

APPENDIX.

UNITED STATES CIRCUIT COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 93—October Term, 1943.

(Argued January 6, 1944 Decided August 8, 1944.)

ESTATE OF EDWARD T. BEDFORD, TITLE GUARANTEE
AND TRUST COMPANY, Executor,

Petitioner,

—against—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before :

L. HAND, AUGUSTUS N. HAND and CHASE,

Circuit Judges.

Petition by Title Guarantee and Trust Company, Executor of the Will of Edward T. Bedford, deceased, to review an order of the Tax Court of the United States determining a deficiency of \$13,887.24 on the part of the Estate of Edward T. Bedford in income taxes for the calendar year 1937. **Reversed.**

HOLT S. MCKINNEY, Attorney for Petitioner;
Erwin R. Griswold and Holt S. McKinney,
Counsel.

SAMUEL O. CLARK, JR., Assistant Attorney General,
Sewall Key and Helen Goodner, Special Assistants to the Attorney General,
for Respondent.

AUGUSTUS N. HAND, *Circuit Judge*:

This appeal involves income taxes of the Estate of Edward T. Bedford, deceased, for 1937, in the amount of \$13,887.24 and is taken from a decision of the United States Tax Court sustaining the assessment of the Commissioner of Internal Revenue. We think the decision of the Tax Court adjudging a deficiency of \$13,887.24 should be reversed.

Edward T. Bedford died on May 21, 1931, and Title Guarantee and Trust Company is the executor of his estate and the taxpayer in this proceeding. Among his assets were 3,000 shares of 7% cumulative preferred stock of Abercrombie and Fitch Company (par value \$100 per share) having a fair market value at the date of his death of \$210,000. Because of business conditions prevailing in the years following Bedford's death Abercrombie and Fitch Company *incurred losses*, with the result that its surplus account showed a cumulative deficit of \$399,771.87 on January 31, 1936. Included in charges against its surplus were amounts aggregating \$844,100 which had been capitalized by three stock dividends issued in 1920, 1928 and 1930. Because of the *deficit occasioned* in the surplus account the Company had been unable for over five years to pay dividends on either its preferred or common stock. Accordingly a plan of recapitalization was proposed and submitted to the stockholders for their consideration and

approval and was adopted by them at a meeting held on December 8, 1936, and thereafter put into effect.

In accordance with this plan, the executor of Bedford received in January, 1937, in exchange for its 3,000 shares of 7% cumulative preferred stock (\$100 par value), the following:

		<i>Fair Market Value</i>
3,500	shares new Cumulative Preferred Stock of the Abercrombie and Fitch Company of a par value of \$75. per share and an annual dividend of \$6. per share	\$288,750.
1,500	shares of the Common Stock of the Abercrombie and Fitch Company of a par value of \$1. per share	15,750.
	Cash of \$15.08 per share	45,240.
Total Fair Market Value		<hr/> \$349,740.

Abercrombie and Fitch Company had net earnings after taxes during the taxable year ended January 31, 1937 of \$309,073.70.

The stock received by the executor of Bedford in exchange for his former holdings was not subject to taxation because it was received through a reorganization and under the provisions of Section 112 (b) (3) of the Revenue Act:

"No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

There concededly was a recognizable gain to the recipient to the extent of the cash distribution of \$45,240 in so far

as this cash and the securities received together exceeded the fair value of the shares the decedent held at the time of his death. This is so because of the provisions of Section 112 (c) (1) that in the case of money so distributed "gain * * * to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property."

It appears from the facts we have stated that the value of the stock Bedford held at the time of his death was \$210,000 and the fair value of the securities and cash received through the reorganization was \$349,740. Accordingly the gain amounted to \$139,740 and the \$45,240 of cash was taxable as a part of such gain if Section 112 (b) (3) should be applied. This, as we understand it, all parties concede. But the Commissioner held and successfully contended before the Tax Court that the cash distribution in pursuance of the plan of reorganization had "the effect of a distribution of a taxable dividend" and, therefore, subdivision 2 of Section 112 (c) (2), and not 112 (c) (1), applied. Section 112 (c) (2) provides that where such a distribution "has the effect of the distribution of a taxable dividend there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess on his ratable share of the undistributed earnings and profits of the corporation cumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property."

We held in *Commissioner vs. Quackenbos*, 78 F. (2d) 156; *Patty vs. Helvering*, 98 F. (2d) 717, and *DeNobili Cigar Company vs. Commissioner*, decided June 20, 1944, that when earnings are once capitalized by the issue of stock dividends they are no longer earnings but capital, except in cases where the purpose of the transaction is not

an honest business purpose but one to avoid taxation. Under those decisions the distribution here was a liquidating dividend and not an ordinary dividend. The slight verbal changes in the provisions of Section 112 (c) (2) and Section 115 (g) seem to us the equivalent of provisions of prior Revenue Acts. We think our decisions are reasonable interpretations of the purpose of the statute and see no just ground for distinguishing between capital raised by the issue of stock dividends and that obtained through subscriptions pro tanto by the shareholders. Here the purpose of the issue of the stock dividends was to add to the capital and the object of the later reduction of the capital stock through the reorganization was to enable the company to resume the payment of dividends when under the state law they could not be paid because the deficit had wiped out the surplus.

But even if the distributions here, according to the theory of the Commissioner and the Tax Court, might have been taken out of accumulated earnings, these distributions should have been charged to capital rather than surplus. In *Foster vs. United States*, 303 U. S. 118, the Supreme Court held that where a corporation had made distributions in redemption of part of its stock they were to be considered distributions in partial liquidation chargeable to capital account and not distributions of surplus. See also *Hellmich vs. Hellman*, 276 U. S. 233, 237.

The distribution here was a "partial liquidation" because all of the old stock of a par value of \$300,000 was surrendered by the decedent for new stock having a par value of only \$264,000. The transaction was evidently a distribution by Abercrombie and Fitch Company "in complete cancellation or redemption of a part of its stock." Such a distribution is a partial distribution as defined in Section 115(i) of the Revenue Act. *Hamman vs. Commissioner*, 121 F. (2d) 4, 7.

The order of the Tax Court is reversed.

RESPONDENT'S BRIEF



(32)
No. 191

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In the Supreme Court of the United States

OCTOBER TERM, 1944

JOHN K. BERTTA, PETITIONER

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF HABITUAL COERCION
STATES CIRCUIT COURT OF APPEALS FOR THE NINTH
CIRCUIT

MEMORANDUM FOR THE COURT

INDEX

CITATIONS

Cases:	Page
<i>Bedford, Edward T., Estate of v. Commissioner</i> , decided August 8, 1944.....	1
<i>Byron Sash & Door Co. v. United States</i> , decided April 10, 1944.....	3
<i>Century Electric Co. v. Commissioner</i> , 3 T. C. 297.....	2
<i>Chapman Price Steel Co. v. Commissioner</i> , decided September 7, 1943.....	2
<i>Commissioner v. Quackenbos</i> , 78 F. 2d 156.....	2
<i>DeNobili Cigar Co. v. Commissioner</i> , 143 F. 2d 436.....	3
<i>Horrnann v. Commissioner</i> , 34 B. T. A. 1178.....	2
<i>Love v. Commissioner</i> , 113 F. 2d 236.....	4
<i>Nolde v. United States</i> , 64 C. Cls. 204, certiorari denied, 276 U. S. 634.....	2, 3
<i>Patty v. Helvering</i> , 98 F. 2d 717.....	2
<i>Van Norman Co. v. Welch</i> , 141 F. 2d 99.....	2
<i>Walker v. Hopkins</i> , 12 F. 2d 262, certiorari denied, 271 U. S. 687.....	2, 3
<i>Young, F. J., Corp. v. Commissioner</i> , 35 B. T. A. 860, affirmed, 103 F. 2d 137.....	2
Statutes:	
Revenue Act of 1936, c. 690, 49 Stat. 1648:	
Sec. 112.....	3
Sec. 115.....	2
Miscellaneous:	
1 Paul & Mertens, <i>Law of Federal Income Taxation</i> , pp. 356-357.....	2
Treasury Regulations 94, Art. 115-11.....	2

(1)



In the Supreme Court of the United States

OCTOBER TERM, 1944

No. 191

JOHN K. BERETTA, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED
STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH
CIRCUIT

MEMORANDUM FOR THE RESPONDENT

The petitioner has filed a reply to the brief in opposition filed by the Government in this case, in which he asserts (pp. 12-15) a direct conflict with the case of *Estate of Edward T. Bedford v. Commissioner* (C. C. A. 2d), decided August 8, 1944 (1944 C. C. H., par. 9441).

The *Bedford Estate* case is in conflict with the decision below insofar as it holds that a stock dividend, which was nontaxable in the hands of the distributees, diminishes earnings and profits. But the petition for certiorari in this case has not raised any question as to the correctness of the decision of the court below that a nontaxable stock dividend does not reduce earnings and

profits. Consequently, the point on which the conflict exists is not involved in the petition for certiorari now before this Court.¹ In any event, the decision below is correct. It is in accord with Section 115 (h) of the Revenue Act of 1936, c. 690, 49 Stat. 1648 (Resp. Br. 16), whereas the *Bedford* decision, we submit, is contrary to Section 115 (h). The decision below is also in accord with the great weight of judicial and administrative authority. See *Van Norman Co. v. Welch*, 141 F. 2d 99 (C. C. A. 1st); *Walker v. Hopkins*, 12 F. 2d 262 (C. C. A. 5th), certiorari denied, 271 U. S. 687; *Nolde v. United States*, 64 C. Cls. 204, certiorari denied, 276 U. S. 634; *Horrmann v. Commissioner*, 34 B. T. A. 1178, 1182; *F. J. Young Corp. v. Commissioner*, 35 B. T. A. 860, 865, affirmed without decision of this point, 103 F. 2d 137 (C. C. A. 3d); *Century Electric Co. v. Commissioner*, 3 T. C. 297, pending on review (C. C. A. 8th); *Chapman Price Steel Co. v. Commissioner*, decided September 7, 1943 (1943 B. T. A. Memorandum Decisions, par. 43,411), pending on review (C. C. A. 7th); Treasury Regulations 94, Article 115-11. See also 1 Paul & Mertens, *Law of Federal Income Taxation*, pp. 356-357.²

¹ In the matter of filing a petition for certiorari in the *Bedford Estate* case on the basis of this conflict and for other reasons is now under consideration by the Government.

² Contrary to this rule are cases decided by the Circuit Court of Appeals for the Second Circuit: *Commissioner v. Quackenbos*, 78 F. 2d 156; *Patty v. Helvering*, 98 F. 2d 717 (both decided under the Revenue Act of 1928, which did not

The *Bedford Estate* case, however is not in conflict with the decision below on the question presented to this Court in the petition for certiorari, namely, whether a reduction in par value of stock constitutes a complete cancellation or redemption of a part of such stock. In the *Bedford* case, old preferred stock was surrendered in a corporate recapitalization, which constituted a reorganization under Section 112 (g) of the Revenue Act of 1936, in exchange for a new class of preferred stock, common stock, and cash. Under Section 112 (c) (1) the gain was recognized on this exchange only to the extent of the cash distribution, and under Section 112 (c) (2) if the cash distribution had the effect of a taxable dividend, it was to be taxed as a dividend insofar as it represented the distributee's share of undistributed earnings accumulated after February 28, 1913. Although the Circuit Court of Appeals for the Second Circuit held that the cash distribution was one in partial liquidation of all the old preferred stock, we believe that the court erred in holding that for

contain a provision similar to Section 115 (h)); and *De-Nobili Cigar Co. v. Commissioner*, 143 F. 2d 436. Also contrary is *Byron Sash & Door Co. v. United States* (W. D. Ky.) decided April 10, 1944 (1944 P-H, par. 62,537), pending on Government's petition for review (C. C. A. 6th).

It will be noted that some of the cases cited in the text above were decided under Revenue Acts which contained no provision analogous to Section 115 (h). See particularly *Walker v. Hopkins*, 12 F. 2d 262 (C. C. A. 5th), certiorari denied, 271 U. S. 687; and *Nolde v. United States*, 64 C. Cls. 204, certiorari denied, 276 U. S. 634.

that reason Section 112 (c) (2) did not apply. The distribution was made in connection with a statutory reorganization, tax-free except for the cash, and the provisions of Section 112 (c) (1) and (2) determined how the gain (to the extent of the cash) should be taxed irrespective of whether or not the distribution might otherwise come under the definition of a distribution in partial liquidation. Such liquidation was only a step in the reorganization and is submerged in the reorganization for tax purposes. See *Love v. Commissioner*, 113 F. 2d 236 (C. C. A. 3d). But in any event, that case did not involve merely a reduction in par value of stock, as does the case before the Court. On the contrary, the old class of preferred stock was entirely surrendered and new classes of stock were issued in its place.

CONCLUSION

The *Bedford Estate* case is not in conflict with the decision below on the holding involved in the petition for certiorari.

Respectfully submitted.

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OCTOBER 1944.

